The Commonwealth of Massachusetts

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

November 5, 2004

D.T.E. 04-47

Petition of The Berkshire Gas Company for approval by the Department of Telecommunications and Energy of a gas portfolio optimization agreement and a gas sales and purchase agreement executed between The Berkshire Gas Company and BP Energy Company.

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I. INTRODUCTION

On April 27, 2004, The Berkshire Gas Company[1] ("Berkshire" or "Company"), pursuant to G.L. c. 164, §§ 76 and 94A, submitted for approval by the Department of Telecommunications and Energy ("Department") a gas portfolio and optimization agreement ("Optimization Agreement") and a gas sales and purchase agreement ("Purchase Agreement") executed with BP Energy Company ("BP"). The Department has approved similar agreements in Berkshire Gas Company, D.T.E. 01-41 (2001) ("2001 Optimization Agreement") and Berkshire Gas Company, D.T.E. 02-19 (2002) ("2002 Optimization Agreement"). The Company's proposal was docketed as D.T.E. 04-47.

On July 23, 2004, pursuant to notice duly issued, the Department conducted a public hearing to afford interested persons the opportunity to comment on the Company's proposal. The Attorney General of the Commonwealth ("Attorney General") intervened as of right, pursuant to G.L. 12, § 11E, and the Department granted NSTAR Gas Company's motion for limited participant status.

On September 9, 2004, the Department held an evidentiary hearing. The Company presented the testimony of Karen Zink, president, chief operating officer, and treasurer of Berkshire. The Company and Attorney General submitted initial briefs on September 24,

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[1] Berkshire is a wholly-owned subsidiary of Energy East Corporation (Exh. BG-2, at 3).

2004, reply briefs on October 1, 2004, and supplemental briefs on October 8, 2004.[2] The evidentiary record consists of 147 exhibits and eleven record requests.

II. DESCRIPTION OF THE PROPOSED AGREEMENTS

A. Request for Proposals Process

The Optimization Agreement is the product of a coordinated effort by Berkshire and four other natural gas local distribution companies ("LDCs") that are regulated subsidiaries of Energy East Corporation ("Energy East") (collectively, "Alliance") (Exh. BG-2, at 3).[3] The Optimization Agreement and Purchase Agreement were executed after issuance of a Joint RFP by the Alliance (id.). The members of the Alliance issued a Joint RFP to 16 potential bidders on November 13, 2003 (Exhs. BG-2, at 7-8; AG 1-19 (confidential); AG 1-39). In December 2003, the Alliance received responses from eleven companies (Exh. BG-2, at 8). The Joint RFP had the following objectives: (1) to secure a strategic alliance that would leverage the gas supply expertise and resources of members of the Alliance with a respondent's supply capability and expertise, marketing and optimization knowledge, financial products, and

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2 The supplemental briefs were limited to issues concerning the Company's audit of the savings produced as a result of the 2002 Optimization Agreement ("2002 Audit"). The 2002 Audit was produced in a supplemental response to Exh. DTE 1-25. Because the 2002 Audit was not available until after the September 9, 2004, evidentiary hearing, the Department permitted the Attorney General to issue an additional round of discovery (Tr. at 3-7). On our own motion, the Department moves the Company's responses to Information Requests AG 3-1 through AG 3-13 into the evidentiary record.

3 The four LDCs are Connecticut Natural Gas Corporation, The Southern Connecticut Gas Company, New York State Electric and Gas Corporation, and Rochester Gas and Electric Corporation (Exh. BG-2, at 3). Maine Natural Gas Company, a smaller affiliated company, also receives some supply-related services from BP but does not directly participate in optimization activities (id.).

information technology; (2) assist the Alliance in maximizing value from gas storage optimization services; (3) provide gas supply arrangements in various supply areas, including gas supply contracts designed to preserve reliability and flexibility while extracting value from optimization techniques; and (4) provide short term gas purchase, balancing and/or capacity arrangements whereby an entity buys services from the members of the Alliance, including delivered city gate supply and market area/city gate balancing services (Exh. AG 1-19 (Att. B) (confidential)).

Bids were evaluated based on price and non-price factors (Exh. AG 1-20). Non-price factors included: (1) the capability to perform the required services; (2) the availability of reliable supplies necessary to meet the Alliance's supply requirements; (3) organizational experience in portfolio services, achievement of savings, and back office capability; (4) the financial strength of the respondent and the ability to provide satisfactory credit support; (5) the ability to manage financial and physical risk; and (6) the expected level of savings to be realized by the Alliance and their customers (id.).

Following the initial evaluation of the bids, the Alliance selected four respondents for further discussion (Exhs. BG-2, at 8; AG 1-20). According to Berkshire, BP's proposal, its experience working with the Alliance, and the system that was already in place, made BP the final candidate for negotiation (Exh. BG-2, at 8). Following the negotiations, the Alliance selected BP as the winning bidder (id.).

Berkshire states that it did not issue an individual RFP for portfolio services because the Company received a very limited response to a company-specific RFP in 2002 (id. at 7).

Consequently, the Company determined that it was more appropriate and cost-beneficial to participate in a coordinated competitive bidding and negotiation process with the other Energy East LDC's (Exhs. DTE 1-19; AG 1-19 (confidential)).

Berkshire argues that the Joint RFP process was substantially similar to the processes followed by the Company and approved by the Department in 2001 and 2002 (Exh. BG-2, at 7-8). The Company argues that the competitive solicitation process was fair, open, transparent, and complied with Department standards (Company Brief at 4). According to Berkshire, the nature of the solicitation was clear to potential bidders and bidders were afforded an opportunity to ask questions or seek clarification of the Joint RFP (id. at 7, citing Exh. AG 1-19 (Att. C)). The Company states that the Alliance did not receive any objections or complaints from bidders regarding the competitiveness, fairness, or transparency of the Joint RFP process (Exh. DTE 1-19; Company Brief at 7, citing AG-1-19 (Att. C)).

Berkshire contends that the Alliance properly determined that the BP's proposal was superior to the alternative proposals with respect to both price and non-price factors (Company Brief at 7-8, citing Exhs. BG-1, at 89; AG 1-26; AG 1-37; Tr. at 147-49). In addition, Berkshire argues that BP's proposal presented the best opportunity for the Company to manage its resources in order to reduce gas costs for customers (id., citing Exhs. BG-1, at 89; AG 1-26; AG 1-37; Tr. at 147-49). The Company states that BP maintains a strong credit rating, which is important to avoid the operational and control-related concerns associated with the insolvency or bankruptcy of an asset manager (id. at 8; citing Exh. DTE 1-27). The Attorney General did not address this issue in his brief.

B. Optimization Agreement

The Optimization Agreement is for a three-year term through and including March 31, 2007, unless Berkshire or BP terminate the contract for any of the specified reasons provided for in the agreement (Exh. BG-4, §§ 3.2, 3.4, 3.6).[4] The Optimization Agreement is designed to provide a mechanism by which Berkshire will work together with BP to enhance the value of the Company's gas portfolio (including transportation, storage, and purchase and sale of natural gas) and to provide Berkshire's customers with least-cost, reliable gas service (Exhs. BG-2, at 3-4; BG-4, § 2.1). Pursuant to the Optimization Agreement, BP will serve as Berkshire's agent and will schedule receipts and deliveries of gas into, and revise nominations from, Berkshire's existing portfolio (Exh. BG-4, § 2.4). The Optimization Agreement specifies that the commodity cost of gas will be determined by the least-cost routing of the gas (id. at § 12.1).[5]

Berkshire's gas costs savings are based on the Company's participation share in the Alliance (Exh. BG-3, § 4.2 (confidential)). Similarly, the Optimization Agreement provides that BP will be compensated based on the incremental savings above individual benchmarks that Berkshire and the other Alliance LDCs realize from BP's efforts (Exh. BG-4, § 4.3).[6]

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4 The 2001 Optimization Agreement was for a one-year period. D.T.E. 01-41. The 2002 Optimization Agreement was for a two-year period. D.T.E. 02-19.

5 Least-cost routing will be determined using production area indices, pre-existing contract prices, and actual pipeline variable costs (Exh. BG-4, § 12.1).

6 The Company executed several ancillary agreements in connection with the Alliance, including an allocation agreement that describes the allocation of savings generated under the Optimization Agreement among the Company and the other members of the

(continued...)

The current Optimization Agreement is similar in structure to the previously approved 2001 Optimization Agreement and 2002 Optimization Agreement (Exh. BG-2, at 3-4). Specifically Berkshire will continue to: (1) retain full control of its gas supply, transportation and storage assets, and all downstream resources including liquified natural gas ("LNG"); (2) have access to various price stability tools; and (3) purchase gas on a least-cost basis, which will allow for continued access to existing supply contracts that contain lower prices (id. at 10).

Pursuant to the Optimization Agreement, a transaction book has been created to record all portfolio transactions (Exh. BG-4, § 2.3). The transaction book will be maintained by BP in a manner that permits the identification of all savings under the Optimization Agreement (id.). The Company will coordinate transactions with the other members of the Alliance through daily conference calls and meetings to ensure that savings are properly allocated to the respective companies (Exh. AG 1-17). In addition, each party to the Optimization Agreement will have the right to inspect and examine the transaction book, together with other books, records, reports, charts, and documents used in connection with the performance of duties and obligations under the Optimization Agreement, to verify the services rendered, processes employed, savings generated, and the accuracy of any billings or information related to the Optimization Agreement (Exh. BG-4, § 11.1).

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6 (…continued)
Alliance (see Exh. BG-3, exh. B-10 (confidential)). The Company also executed a netting agreement that memorializes certain payment or settlement procedures (see Exh. BG-3, exh. B-9 (confidential)).

C. Margin Sharing

The Company proposes to retain 25 percent of the incremental savings generated pursuant to the Optimization Agreement (Exh. BG-2, at 11-12). Specifically, the Company proposes to track all transactions and classify each according to the categories described in Interruptible Transportation/Capacity Release, D.T.E. 93-141-A (1996) (i.e., interruptible sales, capacity release, interruptible transportation, and off-system sales). The Company proposed to retain 25 percent of the savings achieved in each category (id.). Alternatively, the Company proposes to retain 25 percent of all incremental savings on an aggregate basis (id. at 12). Under either alternative, the total amount of savings will be the same.

D. Legal Bills

Berkshire paid $118,000 for legal services rendered in connection with the execution and approval of the 2002 Optimization Agreement (Exh. AG 1-78 (confidential)). This amount has been collected through Berkshire's GAF (id.).

E. Purchase Agreement

Berkshire's proposed Purchase Agreement operates in conjunction with the Optimization Agreement (Exh. BG-6). Under the Purchase Agreement, BP will provide the Company's Gulf Coast production area gas requirements, as well as other quantities of gas that BP and the Alliance mutually agree upon (id.). The Purchase Agreement further provides that if Berkshire learns of the availability of Gulf Coast gas cheaper than that provided for under the Purchase Agreement, the Company has the right to buy the cheaper gas and BP has no right to match the lower cost (Exhs. BG-6, Art. IV; BG-4, § 2.7). Pricing under the Purchase

Agreement is based on market indices and a supply reservation charge (Exh. BG-5, Art. V (confidential)). Finally, the Optimization Agreement provides that Berkshire must satisfy its purchase obligations under the Company's other gas supply agreements in its portfolio before purchasing gas from BP (Exh. BG-4, § 2.7).

III. POSITIONS OF THE PARTIES

A. Request for Proposals Process

Berkshire states that it did not issue an individual RFP for portfolio services because the Company received a very limited response to a company-specific RFP in 2002 (id. at 7). Consequently, the Company determined that it was more appropriate and cost-beneficial to participate in a coordinated competitive bidding and negotiation process with the other Alliance LDC's (Exhs. DTE 1-19; AG 1-19 (confidential)).

Berkshire argues that the Joint RFP process was substantially similar to the processes followed by the Company and approved by the Department in 2001 and 2002 (Exh. BG-2, at 7-8). The Company argues that the competitive solicitation process was fair, open, transparent, and complied with Department standards (Company Brief at 4). According to Berkshire, the nature of the solicitation was clear to potential bidders and bidders were afforded an opportunity to ask questions or seek clarification of the Joint RFP (id. at 7, citing Exh. AG 1-19 (Att. C)). The Company states that the Alliance did not receive any objections or complaints from bidders regarding the competitiveness, fairness, or transparency of the Joint RFP process (Exh. DTE 1-19; Company Brief at 7, citing AG-1-19 (Att. C)).

Berkshire contends that the Alliance properly determined that the BP's proposal was superior to the alternative proposals with respect to both price and non-price factors (Company Brief at 7-8, citing Exhs. BG-1, at 89; AG 1-26; AG 1-37; Tr. at 147-49). In addition, Berkshire argues that BP's proposal presented the best opportunity for the Company to manage its resources in order to reduce gas costs for customers (id., citing Exhs. BG-1, at 89; AG 1-26; AG 1-37; Tr. at 147-49). The Company states that BP maintains a strong credit rating, which is important to avoid the operational and control-related concerns associated with the insolvency or bankruptcy of an asset manager (id. at 8, citing Exh. DTE 1-27). The Attorney General did not address this issue in his brief.

B. Optimization Agreement

1. Berkshire

Berkshire claims that the Attorney General's arguments concerning the Optimization Agreement are misleading, erroneous, and not supported by evidence (Company Reply Brief at 2). The Company asserts that the Optimization Agreement is consistent with Department precedent (Company Brief at 10, 22). The Company argues that many provisions of the Optimization Agreement and the Company's overall resource plan have been previously approved by the Department (id. at 15-16, citing Berkshire Gas Company, D.T.E. 02-17; D.T.E. 01-41, at 11; D.T.E. 02-19; Berkshire Gas Company; D.T.E. 98-99 (1999)).

The Company argues that a three-year term is appropriate because (1) the Alliance has had three years experience working with BP, (2) the present Optimization Agreement is materially the same as the previous agreements, and (3) a three-year term provides continuity and avoids the start-up issues associated with a new Alliance partner (Company Brief at 10). According to the Company, compared to an asset management arrangement, the Optimization Agreement provides the maximum opportunity for Berkshire to achieve savings for its customers (id. at 17, citing Exhs. BG-3, Art. IV; BG-1, at 6, 9; Tr. at 56).

Berkshire claims that the Optimization Agreement will produce additional savings over and above those levels achievable by the Company alone (Company Brief at 11, 13, 18, citing Exh. BG-3, Art. IV; D.T.E. 02-19, at 14). Berkshire contends that, even if no savings are realized, BP will make guaranteed payments to the Company and the other Alliance LDCs and Berkshire will only pay BP for the commodity cost of the gas (id. at 12, citing Exhs. BG-1, at 9; BG-3, Art. IV; D.T.E. 02-19, at 17, n.13). Further, Berkshire asserts that the Optimization Agreement is structured to ensure that BP has an appropriate incentive to maximize the Company's savings and help it obtain natural gas at the lowest possible cost (id. at 12).

Berkshire argues that the Optimization Agreement imposes no additional risks on the Company or its customers (id. at 18). The Company states that the Optimization Agreement requires the purchase price of natural gas to be at the lowest available marginal commodity cost and that Berkshire will not pay more for natural gas under the Optimization Agreement than it would have without the Optimization Agreement (id., citing Exhs. BG-3, Arts. XII, XIII; B-2; D.T.E. 01-41, at 11-12; D.T.E. 02-19, at 16).

The Company contends that, despite the Attorney General's claims to the contrary, Berkshire has adequately complied with all Department reporting requirements (Company

Reply Brief at 8, citing Attorney General Brief at 4). Berkshire asserts that the Company will continue to retain control over its resources and dispatch decisions on a daily basis (Company Brief at 16). The Company states that it will continue to review weather forecasts, and evaluate load requirements, storage inventories, market conditions, and conditions on the Tennessee Gas pipeline to ensure that gas is dispatched on a least-cost basis and that service reliability is maintained (id., citing Exh. DTE 1-16). Further, the Company states that it will continue to review with the Alliance daily how much gas is required for the day and discuss opportunities available to optimize the portfolio (id. at 16, citing Exhs. AG 1-17; AG 1-22 (Att. B)). In addition, the Company states that it will monitor and review transactions under the Optimization Agreement on a daily basis to ensure that the needs of its customers are met (id.).

Berkshire argues that, contrary to the Attorney General's contention, it has correctly interpreted and applied the Department's precedent concerning derivatives (Company Reply Brief at 9, n.11 citing Attorney General Brief at 5, n.7). The Company maintains that it will not engage in any speculative financial arrangements under the Optimization Agreement (Company Brief at 19, citing Exhs. BG-3, exh. B-3 (confidential)). The Company states that it will continue to comply with the Department's directives with respect to any speculative financial arrangements (id., citing D.T.E. 02-19, D.T.E. 01-41).

With regard to the Attorney General's assertion that BP's reporting procedures under the previous agreements were lacking, Berkshire states that the Company has recognized the need for more timely and complete documentation of portfolio optimization activity (Company

Reply Brief at 9). Accordingly, the Company states that its operating procedures with BP were revised to include many of the specific enhancements suggested in the 2002 Audit (Company Brief at 21, citing Exhs. AG 1-22 (Att. A) (confidential); DTE 1-25 (Supp.) (confidential)). Finally, Berkshire states that it needed more time to complete its 2002 annual report and that it alerted the Department about the delay (Company Reply Brief at 9, citing Tr. at 85-86).

2. Attorney General

The Attorney General argues that the Optimization Agreement is not in the public interest and, therefore, urges the Department to reject it (Attorney General Brief at 4-8). Specifically, the Attorney General contends that Berkshire lacks the necessary internal and external control mechanisms to prevent BP from using derivative transactions under the Optimization Agreement for speculative purposes (id. at 4-5).[7] The Attorney General states that Energy East's derivatives policy has not been explicitly examined or approved by the Department (id. at 5, citing Exh. BG-4, §§ 2.6, 6.2(c) at 37; Attorney General Supplemental Brief at 1). In addition, the Attorney General claims that the Optimization Agreement does not require BP to retain and provide complete, detailed information regarding its derivative activity to Energy East's audit committee for review (Attorney General Brief at 5). According to the Attorney General, the lack of an internal control mechanism over BP's derivative transactions will expose the Company's ratepayers to the risk of harm from BP's poor financial decisions

[7] According to the Attorney General, the Department permits the use of derivatives for hedging, but not for speculative purposes (Attorney General Brief at 5, n.5, citing D.T.E. 01-41, at 14).

(id. at 7-8, citing Berkshire Gas Company, D.T.E. 03-89, at 31-32 (2004)). Moreover, the Attorney General argues that Energy East's 2002 Audit is inconclusive as to whether BP has acted in Berkshire's ratepayers' interests (Attorney General Supplemental Brief at 1).

The Attorney General also argues that the Optimization Agreement is not in the public interest because the allocation of savings favors BP at the expense of Berkshire and its customers (Attorney General Brief at 6). The Attorney General contends that, under the 2001 Optimization Agreement and 2002 the Optimization Agreement, BP was allowed to retain monetary benefits even as Berkshire's savings were reduced (id.). The Attorney General argues that the same could happen under the present Optimization Agreement because Berkshire agreed to accept less in terms of minimum guaranteed savings than the Company was entitled to under the 2002 Optimization Agreement (id. at 6, citing Exh. AG 1-2 (confidential)). Finally, the Attorney General claims that the Optimization Agreement exposes the Company's ratepayers to "an elevated risk of harm" because, under the scope of the agency provisions, Berkshire can be held responsible for BP's actions for the three-year term of the agreement (id., citing Exh. BG-4, § 2.4).

Alternatively, the Attorney General argues that, if the Department approves the Optimization Agreement, the approval should be conditioned on Berkshire instituting policies to protect the Company's ratepayers (Attorney General Brief at 8). The Attorney General suggests that the Department should require Berkshire to: (1) engage an independent auditor to determine that all transactions under the proposed Optimization agreement, including BP's derivative activities, and allocations are made in the best interest of the Company's customers;

(2) file annual reports with the Department in a timely manner;[8] (3) seek prior approval from the Department for all proposed substantive changes to the Optimization Agreement and related agreements;[9] (4) conduct a comprehensive external audit of all BP transactions under the 2001 Optimization Agreement and 2002 Optimization Agreement to determine whether the activities BP and the Alliance performed were consistent with Department orders and precedent, and were in the best interests of the Company's customers; (5) report the amount of Berkshire's gas subjected to the demand/reservation charge and assess whether the amount resulted in least-cost pricing for Berkshire's customers; (6) increase the weighting of the back office

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8 The Attorney General states that, in D.T.E. 02-19, the Department required Berkshire to submit annual reports within 60 days of the end of every contract year that: (1) contain detailed documentation of all BP portfolio optimization transactions; (2) detail any refinements made to the allocation method; (3) list the savings dollars accrued to the Company; (4) describe how savings were generated and allocated between the LDCs in the Alliance; (5) summarize BP's transactions on behalf of the Company; (6) highlight problems that arose during implementation of the 2002 Optimization Agreement and related agreements; and (7) describe how the Company and BP dealt with any implementation problems (Attorney General Brief at 4, n.4, citing D.T.E. 02-19, at 19)). The Attorney General states that Berkshire filed its 2003 report within the required 60-day period but the Company's 2004 report was one week late (Attorney General Brief at 4, n.4, citing Exhs. AG 1-4, AG 1-31).

9 According to the Attorney General, Berkshire has agreed to submit all amendments, supplements, or substantive changes to the Optimization Agreement to the Department for approval (Attorney General Brief at 8, n.17, citing Exhs. DTE 1-35, 1-36; Tr. at 79, 145, 172). The Attorney General contends that the definition of "substantive changes" should include changes that directly or indirectly increase Berkshire's cost of gas adjustment ("CGA") costs, including, but not limited to, changes (1) the Company's participating share; (2) the allocation procedures; (3) any pricing term, including the aggregate minimum savings; and (4) the resources available to the Alliance (Attorney General Brief at 8, n.17).

system category[10] in any future Joint RFP; (7) update the Department annually on BP's enhancements to correct deficiencies in its back office systems; and (8) submit a final external, independent audit report to the Department prior to seeking a renewal or extension of the Optimization Agreement or before Berkshire issues any additional request for proposals ("RFP") to optimize the Company's gas supply assets (Attorney General Brief at 8-9; Attorney General Supplemental Brief at 1).

C. Margin Sharing

1. Berkshire

Berkshire claims that it has worked creatively to establish the Alliance to maximize the overall benefit to ratepayers, and that the opportunity to share margins is an appropriate reward for its aggressive pursuit of optimization opportunities (Company Brief at 23). According to Berkshire, transactions conducted under the Optimization Agreement are the same type of transactions described in D.T.E. 93-141-A and, therefore, the Department should apply its established margin-sharing principles to any savings generated by the portfolio optimization activities (id., citing Exh. BG-1, at 11-12).

The Company disputes the Attorney General's comparison of Optimization Agreement activities to price-volatility mitigation efforts (Company Reply Brief at 15-16). Rather, the Company argues that optimization does not reduce volatility (id. at 16). The Company states that its margin-sharing proposal is consistent with its goal to generate and return margins to

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10 The "back office system" refers to the administrative capability to handle the data, communication, billing, reporting a tracking required under the Optimization Agreement.

ratepayers (id.). Finally, the Company argues that its margin-sharing proposal is consistent with the criteria cited by the Attorney General as pre-requisites for incentive recovery (id. at 17-18, citing Attorney General Brief at 14).

2. Attorney General

The Attorney General states that the Department should not approve Berkshire's margin-sharing proposal (Attorney General Brief at 14; Attorney General Reply Brief at 4). The Attorney General argues that the Department has approved margin sharing for only four categories of revenues (i.e., interruptible sales, capacity release, interruptible transportation, and off-system sales), and not for savings associated with a portfolio optimization agreement (Attorney General Brief at 9-10; Attorney General Reply Brief at 4).

The Attorney General contends the Department should reject Berkshire's margin-sharing proposal because, under the optimization agreement, the participants share both the costs and the benefits. Although the Company argues that the Optimization Agreement is similar to capacity management agreement, where the Department has approved margin sharing, the Attorney General disagrees. Specifically, with a capacity release, agreement, the Attorney General argues that the LDC receives a fixed price for the sale of an asset and bears no costs associated with capacity (id. at 12).

In addition, the Attorney General states that the Department has rejected the use of incentive hedging as a means to reduce price volatility, in part because incentives could negatively affect the development of retail competition (id. at 10-11, citing Risk Management Techniques, D.T.E. 01-100-A at 24 (2002)). The Attorney General asserts that, because one of the expected benefits of the Optimization Agreement is enhanced risk management and price stability, the Department must reject the margin-sharing proposal (id. at 11).

Alternatively, the Attorney General asserts that if Berkshire's margin-sharing proposal is approved, the Department should ensure that the Company earns such incentives only when: (1) the Company clearly demonstrates that there are proven benefits to ratepayers; (2) the Company conducts an independent assessment that shows the activities being encouraged have been reported accurately; (3) the activities are done for the benefit of the Company's ratepayers; and (4) any program that incorporates incentives also ensures that ratepayers receive safe, reliable, least-cost service (id. at 14).

D. Legal Bills

1. Berkshire

Berkshire states that because it had an existing gas asset management plan in place during the test year for its last rate case, the Company did not seek to recover legal costs for gas acquisition activities at that time (Company Reply Brief at 19-20, citing Tr. at 173-175; Berkshire Gas Company, D.T.E. 99-81 (1999)). Therefore, Berkshire argues that the Company's base rates do not recover any costs associated with gas optimization activities and that to preclude recovery of legal costs related to the 2002 Optimization Agreement would have the effect of punishing Berkshire for pursuing optimization opportunities (id. at 18-21). Further, Berkshire argues that its cost of gas adjustment clause ("CGAC") tariff permits recovery for expenses for procuring gas supplies, so long as costs recoverable through the CGAC are not also in base rates (id. at 21). Therefore, Berkshire contends that legal costs related to the 2002 Optimization Agreement were appropriately recovered through its CGAC (id.).

2. Attorney General

The Attorney General objects to Berkshire's recovery of legal fees rendered in connection with the 2002 Optimization Agreement. The Attorney General states that Berkshire's recoverable gas acquisition costs and legal fees were determined in the Company's last rate case and that this amount was allocated between base rates and the gas adjustment factor ("GAF") (Attorney General Brief at 15). Therefore, by including legal costs related to the 2002 Optimization Agreement in its GAF, the Attorney General contends that the Company has inappropriately increased its GAF by $118,000 (Attorney General Brief at 15-16; Attorney General Reply Brief at 4-5).

The Attorney General disputes Berkshire's contention that legal fees were approved when the Department approved the Company's GAF for 2003 and 2004 (Attorney General Reply Brief at 4, citing Western Massachusetts Electric Company, D.T.E. 03-34, at 6 (2004); Boston Gas Company, D.P.U. 96-50-C (Phase I) at 33 (1997), citing Robinson v. Department of Public Utilities, 416 Mass. 668, 673 (1993), NYNEX, D.P.U. 94-50, at 444 (1995); Fitchburg Gas and Electric Light Company, D.T.E. 99-66-A at 24 (2001)). Accordingly, the Attorney General argues that the Department should direct Berkshire to recalculate its GAF reconciliations for 2003 and 2004 to remove the $118,000 in legal fees, and refund this amount with interest in the Company's next GAF filing (Attorney General Brief at 15-16; Attorney General Reply Brief at 4-5).

E. Purchase Agreement

Berkshire argues that the Purchase Agreement is in the public interest because it provides a least-cost, flexible resource, enabling the Company refine its supply portfolio (Company Brief at 14). Specifically, Berkshire asserts that the Purchase Agreement provides the Company with greater flexibility to procure Gulf Coast gas more cheaply (id.). Finally, Berkshire argues that the Purchase Agreement helps the Company maintain reliability due to the vast resources of BP (id. at 15). The Attorney General did not address this issue.

IV. STANDARD OF REVIEW

In evaluating a gas utility's resource options for the acquisition of commodity resources as well as for the acquisition of capacity under G.L. c. 164, § 94A ("Section 94A"), the Department examines whether the acquisition of the resource is consistent with the public interest. Commonwealth Gas Company, D.P.U. 94-174-A at 27 (1996). In order to demonstrate that the proposed acquisition of a resource that provides commodity and/or incremental resources is consistent with the public interest, an LDC must show that the acquisition (1) is consistent with the company's portfolio objectives and (2) compares favorably to the range of alternative options reasonably available to the company and its customers, including releasing capacity to customers migrating to transportation, at the time of the acquisition or contract negotiation. Id.

In establishing that a resource is consistent with the company's portfolio objectives, the company may refer to the portfolio objectives established in a recently approved forecast and requirements plan or in a recent review of supply contracts under Section 94A, or may describe its objectives in the filing accompanying the resource proposal. Id. In comparing the proposed resource acquisition to current market offerings, the Department examines relevant price and non-price attributes of each contract to ensure a contribution to the strength of the overall supply portfolio. Id. at 28. As part of the review of price and non-price attributes, the Department considers whether the pricing terms are competitive with those of the broad range of capacity, storage, and commodity options that were available to the LDC at the time of the acquisition, as well as those opportunities that were available to other LDCs in the region. Id. In addition, the Department determines whether the acquisition satisfies the LDC's non-price objectives, including, but not limited to, flexibility of nominations and reliability and diversity of supplies. Id. at 29. In making these determinations, the Department considers whether the LDC used a competitive solicitation process that was fair, open and transparent. The Berkshire Gas Company, D.T.E. 02-56, at 9; Bay State Gas Company, D.T.E. 02-52, at 8 (2002); KeySpan Energy Delivery New England , D.T.E. 02-54, at 9 (2002); The Berkshire Gas Company, D.T.E. 02-19, at 11 (2002).

V. ANALYSIS AND FINDINGS

A. Request for Proposals Process

A RFP process is acceptable if the process was "fair, open and transparent." D.T.E. 98-32-B at 54-55. The Department approved the RFP processes used by the Company in 2001 and 2002, finding that the processes were appropriately conducted, fair, open, and transparent. D.T.E. 01-41, at 14, and D.T.E. 02-19, at 11. In the instant proceeding, the bid solicitation and evaluation process was similar to the processes approved in D.T.E. 01-41 and

D.T.E. 02-19. The Joint RFP evaluation process was clearly explained to each potential bidder and evaluation criteria were provided. Bidders were given the opportunity to request clarification of the evaluation criterial and the Joint RFP process itself (Exh. AG 1-19 (confidential)). In addition, bids were evaluated and the winning bid was selected based on the criteria set forth in the Joint RFP (id.). Further, no objection to the Joint RFP process was raised by bidders or potential bidders (id.). Accordingly, the Department finds that the Joint RFP process conducted by Berkshire and the Alliance was open, fair, transparent and, therefore, acceptable.

B. Optimization Agreement

The Department's review of Berkshire's proposal indicates that the Optimization Agreement is consistent with the portfolio objectives presented in the Company's most recent forecast and supply plan approved by the Department in Berkshire Gas Company, D.T.E. 02-17 (2003). In addition we find that the Optimization Agreement with BP compares favorably to the range of alternatives available to Berkshire and its customers. Under the proposed Optimization Agreement, BP will provide day-to-day consulting services to Berkshire regarding the use of the Company's resource portfolio, including upstream interstate supply, transportation, and underground storage, to provide reliable and least-cost service to its customers (Exhs. BG-2, at 3-4; BG-4, §§ 2.1, 2.4). The commodity and capacity contracts approved by the Department in D.T.E. 02-17 will be maintained under the proposed Optimization Agreement. Moreover, the pricing provisions of these contracts will not change under the Optimization Agreement and BP will not have the right to terminate, renew, modify, or amend any contract or agreement previously entered into by Berkshire (Exhs. BG-4, § 2.4; DTE 1-5; Tr. at 69-71). In addition, BP will not have the exclusive right to supply Gulf Coast production gas by matching lower prices offered by an alternative supplier and BP will not play a role in negotiating any new contracts that the Company might enter into with third parties (Exhs. BG-2, at 10; BG-4, §§ 2.4, 2.7; DTE 1-5; Tr. at 69-71).

Therefore, even in the absence of savings from the proposed Optimization Agreement, Berkshire's resource portfolio will still be least-cost and the Company's customers will pay no more for natural gas under the Optimization Agreement than they would have without it. (Exh. BG-4, § 12.1). In fact, the Optimization Agreement is likely to benefit Berkshire's customers in the form of lower gas supply costs.[11]

The Attorney General argues that the present agreement is less favorable to Berkshire's customers when compared to the 2002 Optimization Agreement because the Company has agreed to accept less in terms of minimum guaranteed savings (Attorney General Brief at 6). The savings Berkshire can reasonably expect to achieve are determined by the Company's participating share in the Alliance, as well as optimization opportunities available in the market, as affected by liquidity, storage levels, and weather conditions (Exhs. DTE 1-9 (confidential); AG 1-7; AG 1-8).[12] Berkshire's participating share in the Alliance decreased

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[11] The Department notes that Berkshire achieved savings under the previous agreements (Exh. BG-1, at 5; Company's June 17, 2003 Annual Report; Company's August 5, 2004 Annual Report; Tr. at 22). The savings were returned to the Company's ratepayers through the GAF (Exh. AG 1-48).

[12] For example, dramatically cold weather offers limited opportunity for LDCs to seek

(continued…)

from 6.67 percent in 2002 to 6.0 percent, largely as a result of Rochester Gas and Electric Corporation's addition to the Alliance (Exh. BG-2, at 3; Tr. at 92-95).[13] Also, the downward adjustment of the aggregate minimum guaranteed savings was based on BP's assessment of market conditions (Exh. BG-1, at 10). Therefore, we find that the minimum guaranteed savings under the present Optimization Agreement are reasonable.

In addition, the Attorney General contends that the Optimization Agreement exposes Berkshire's customers to "an elevated risk of harm" (Attorney General Brief at 6). We disagree. The terms of the proposed Optimization Agreement are substantially similar to the 2001 Optimization Agreement and 2002 Optimization Agreement, therefore, any risks to Berkshire's customers will not be higher than they were under the previous agreements (Exh. BG-2, at 10; AG 1-27). Moreover, Berkshire will incur no costs from any transactions entered into by BP under the proposed Optimization Agreement (Exhs. DTE 1-1; DTE 1-14). Further, the Company has confirmed that it will not engage in any speculative financial arrangements under the Optimization Agreement and it will comply with all prior Department directives with respect to any speculative financial transactions (Exhs. BG-3, exh. B-3 (confidential); DTE 1-14). Therefore, we find that the Optimization Agreement does not expose Berkshire's customers to an elevated risk of harm. Because the Optimization Agreement is consistent with

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12 (…continued)
optimization savings because of the need to retain their supply resources to ensure service reliability.

13 Rochester Gas and Electric Corporation did not participate in the 2002 Optimization Agreement (Exh. BG-2, at 3).

the Company's resource portfolio objectives and compares favorably to the range of alternatives reasonably available to the Company and its customers, the Department finds that the Optimization Agreement is consistent with the public interest and is approved.[14]

With regard to the Attorney General's concerns about Energy East's 2002 Audit of the Optimization Agreement, Berkshire has shown that the audit was performed by qualified personnel with training and expertise in internal auditing (Exhs. AG 3-1, Att. A at B-1 (confidential), AG 3-2 (confidential)). There is no basis on which to conclude that the use of internal Energy East personnel influenced the outcome of the Audit. Therefore, we will not require the Company to conduct an additional internal audit of all BP transactions under the 2001 and 2002 agreements. The Company indicated that an external auditor will conduct an evaluation of Berkshire's finances, including a review of the savings under the Optimization Agreement (Tr. at 83-84). While we will not require an additional external audit at this time, we direct the Company to provide the Department with a copy of the external auditor's evaluation as soon as it is available. In addition, Berkshire must continue to provide the Department with Energy East's annual audits of the Optimization Agreement.

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14 The Department's objective is not to dictate a precise plan for resource or capacity acquisition but, rather, to ensure that the manner in which a company proposes to acquire resources and capacity is consistent with the public interest. By demonstrating that the Company's ratepayers will likely benefit from the Alliance arrangements under the most unfavorable optimization conditions, we find that the Alliance arrangement contributes to an overall least cost resource plan and, thus, is consistent with the public interest. See D.T.E. 02-19, at 16, n.13

Regarding the Attorney General's concerns about BP's reporting procedures, we find that Berkshire and BP must continue to work together to streamline and improve BP's back office systems. The Company is directed to keep detailed documentation of all transactions under the Optimization Agreement and submit an annual report to the Department containing a summary of all transactions on behalf of the Company. In addition, the annual reports should describe any proposed substantive changes to the Optimization Agreement, including refinements to the allocation method, the Company's participation share, pricing provisions, and changes to the aggregate minimum savings. The annual reports should also include the dollar amount of savings accrued to the Company with an explanation of how such savings were generated and allocated between the Alliance LDCs. Finally, the annual reports should highlight any problems that arose during the implementation of the Optimization Agreement, including any issues with BP's back office systems and reporting procedures, and discuss the steps that the Company and BP have taken to address these problems. Berkshire must submit such annual reports no later than April 1st of each year.

C. Margin Sharing

The Department has acknowledged that the regulatory policy of requiring all margins derived from capacity-management tools (i.e., interruptible sales, capacity release, interruptible transportation, and off-system sales) to flow to firm customers can result in a disincentive for LDCs to make investments that are in the public interest. D.P.U. 93-141-A at 59. Similarly, the Department has recognized that when giving utilities financial incentives to improve efficiency and a greater share of the resulting cost savings, real benefits to customers can be achieved. Id., citing Incentive Regulation, D.P.U. 94-158, at 47-52 (1995). The Department has stated that the ability of LDCs to take advantage of market opportunities allows them to generate additional margins that could reduce the average cost of service to firm customers. D.P.U. 93-141-A at 59-60. Consequently, LDCs are allowed to retain 25 percent of annual incremental margins earned from interruptible sales, interruptible transportation, off-system sales, and capacity release. D.P.U. 93-141-A at 64. More recently, the Department has found that LDCs should not be penalized with the loss of capacity-mitigation revenues as a result of pursuing a portfolio-management approach that will produce benefits for customers. Boston Gas Company, Colonial Gas Company, and Essex Gas Company, D.T.E. 99-76, at 22.[15]

As an initial matter, the Attorney General agues that, because the goal of the Optimization Agreement is to reduce costs, the Company's proposal is ineligible for margin sharing (Attorney General Brief at 11).[16] However, we find that the Attorney General has

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15 In D.T.E. 99-76, at 6-7, the Department approved a contract whereby an independent portfolio manager would assume the right to manage the three LDCs' combined portfolios in exchange for a management fee payable to the LDCs. Id. at 6-7. The Department also approved the LDCs' proposal to retain 25 percent of revenues received under the portfolio agreement. Id. at 23.

16 The Department has rejected incentive mechanisms in conjunction with LDCs' risk-mitigation programs, finding that they (1) would not be consistent with the Department's goal of promoting market-based regulation and enhanced competition in that it would not serve as a vehicle to a more competitive environment; and (2) could negatively affect the development of retail competition and customer choice in Massachusetts. D.T.E. 01-100-A at 24, citing Incentive Regulation at 59. The Department stated that incentive mechanisms would be more appropriately associated with programs whose objective is to lower costs or increase service quality, rather than (continued...)

mis-characterized the Company's proposal and the Optimization Agreement. Berkshire has not submitted a proposal to mitigate price volatility. Rather, the Optimization Agreement has been structured with the ultimate goal of reducing costs to the Company's firm customers. Under the Optimization Agreement, the Company will use financial instruments to reduce commodity costs and strategies to mitigate capacity. Therefore, we find that, similar to the agreement approved by the Department in D.T.E. 99-76, the transactions under the Optimization Agreement are eligible for margin sharing.

With respect to the structure of Berkshire's margin sharing proposal, the arrangement is consistent with the criteria set forth in D.P.U. 93-141-A. Specifically, the Company's proposal complies with the Department's directives with regard to the allocation of margins, the applicable threshold level, as well as the percentage of margins to be retained by Berkshire. Failure to approve Berkshire's proposed treatment of margins would eliminate all incentives by the Company to seek arrangements such as the current portfolio optimization structure and penalize Berkshire for pursuing such activities with loss of capacity-mitigation revenues, which the Company could earn absent this Optimization Agreement.

Therefore, because Berkshire's portfolio optimization activities under the Optimization Agreement are designed to reduce costs to ratepayers and the margin sharing arrangement is consistent with the criteria set forth in D.P.U. 93-141-A, Berkshire's margin sharing proposal is approved. In flowing back the margins via the GAF and the local distribution adjustment

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[16] (…continued)
with financial hedging programs whose objective is to mitigate price volatility. Id. at 22.

factor filings, we direct the Company to track and record each transaction margin in a manner consistent with D.P.U. 93-141-A.

The Attorney General contends that any margin sharing by the Company should be subject to certain conditions. First, the Attorney General argues that the Department should allow the Company to earn incentives only when the Company's activities can be shown to offer proven benefits (Attorney General Brief at 12-13). However, by the terms of its proposal, Berkshire will earn margins only if savings (and, therefore, ratepayer benefits) are generated in excess of the savings from the same activities in the previous year.

Second, the Attorney General argues that the Company should be required to have an independent assessment performed to ensure reporting accuracy before any margin sharing is allowed (Attorney General Brief at 14). However, Berkshire indicated that an external auditor will be evaluating savings under the Optimization Agreement and will submit the resultant data to the Department (Tr. at 83-85). Therefore, as we stated in Section V.B. above, we will not require an independent external audit at this time.

D. Legal Bills

The amount of gas acquisition, planning, and dispatching costs ("gas acquisition costs") that a company may recover is determined in the company's rate case. See Boston Gas Company, D.P.U. 93-60, at 281 (1993). This amount is then recovered via the company's GAF. Gas acquisition cost is a fixed amount that is recovered annually until the company's next rate case. Id. at 282. In other words, in between rate cases, a company's gas acquisition cost cannot be changed from the amount determined in its last base rate proceeding.[17]

In context of the Department's review of the 2002 Optimization Agreement approved in D.T.E. 02-19, the Company did not propose to recover legal fees through its GAF for services rendered in connection with gas portfolio and optimization activities. As a result, the Department did not approve the collection of legal fees for such activities.

In the instant proceeding, Berkshire argues that its recovery of $118,000 in legal fees through the GAF is appropriate because such fees are associated with its efforts to procure gas supply (Company Brief at 21). The legal fees incurred by the Company for its portfolio optimization activities are gas-supply related and, therefore, constitute gas acquisition costs. However, as we stated above, the amount of gas acquisition costs that a company may recover is fixed and does not change until the company's next rate case filing. In the Company's last rate case, although Berkshire had an asset management plan in place, the Company did not propose to include legal fees associated with gas optimization activities as an adjustment to its test year amount of gas acquisition costs. The Company cannot now seek recovery of these costs outside of the amount determined in its last rate case.

Therefore, because Berkshire's gas acquisition costs were determined in the Company's last base rate proceeding, the Department finds that the Company has inappropriately collected

[17] The Company's witness stated that Berkshire was familiar with the Department's precedent concerning the recovery of gas acquisition costs, namely that "the costs of gas acquisition are set in a company's rate case at a set amount, and they are recovered pursuant to the CGA" (Tr. at 63-64).

$118,000 in gas acquisition costs via its GAF. Accordingly, in Berkshire's next GAF filing, we direct the Company to refund, with interest, any legal fees associated with gas optimization activities that it has already collected via its GAF. Similarly, Berkshire may not collect legal fees for services rendered in connection with the instant proceeding in the Company's next GAF filing.

E. Purchase Agreement

The Department's review of the proposed Purchase Agreement indicates that it is consistent with Berkshire's resource portfolio objectives presented in the Company's most recent forecast and requirements plan approved by the Department in D.T.E. 02-17. As we found above, BP's resources compare favorably to the range of alternatives reasonably available to the Company and its customers. Further, unlike the Company's 2002 Purchase Agreement, Berkshire is no longer limited to procuring Gulf Coast gas supplies from BP (Exh. BG-3, §2.7).[18] Accordingly, the Department finds that the Purchase Agreement is consistent with the public interest and is approved.

VI. ORDER

Accordingly, after due notice, hearing, and consideration, it is

ORDERED: That the Optimization Agreement and Purchase Agreement between The Berkshire Gas Company and BP Energy Company are APPROVED; and it is

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[18] The Department has stated that a company should not limit the purchase of its gas supply requirements to one supplier. D.T.E. 01-41, at 12, citing Commonwealth Gas Company, D.P.U. 94-174-A (1996).

FURTHER ORDERED: That The Berkshire Gas Company shall comply with all other directives contained in this Order.

By Order of the Department

/s/
____
Paul G. Afonso, Chairman

/s/
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James Connelly, Commissioner

/s/
____
W. Robert Keating, Commissioner

/s/
____
Eugene J. Sullivan, Jr., Commissioner

/s/
____
Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).